R9850-3

Tax Foundation Vol. 34, No. 7 July/August 1990

Tax Features

'Bubbles' Abound in Tax Code, Used by Legislators to Enhance Progressivity

When legislators suggest that we "pop the bubble" in the individual income tax rates, they usually describe the bubble as an "anomaly" or "mistake." Their proposals are supposedly a "correction" or "clarification" of the tax code, as if the code were a simple, elegant structure with one nail sticking up out of it, and all we have to do is hammer it down. Nothing could be further from the truth.

The tax code is in fact enormously complex and is filled with with many so-called bubbles. How do they occur and what does popping them really mean?

The notorious bubble in the individual income tax rate structure arises because of two special provisions under the code: 1) Income below $18,550 (single filers) is taxed at 15 percent rather than at the 28 percent marginal rate to which all other income is subject; 2) Each taxpayer is entitled to a personal exemption of $2,050 (1990). The money saved by using the 15 percent rate, $2,412, [(28%–15%) * $18,550] and from the personal exemption, $574, (28% * $2,050) is recouped from the taxpayer by adding an extra 5 percent tax to the 28 percent top statutory rate. This 33 percent rate is applied to income between $44,900 and $104,610 (for single individuals) until the $2,986 is fully recovered.

In other words, to take away from high-income earners the advantage of both the 15 percent rate and the personal exemption, a 5 percent surcharge is imposed on a specific range of income — at the beginning of the range, the marginal rate rises; at the end it falls back, forming the bubble.

It is the lower marginal rate for income beyond the bubble that proponents of bubble-popping claim to be unfair. But they rarely if ever point out that the bubble is only in marginal rates, not effective rates. With the bubble in place, no taxpayer ever pays a lower effective rate by earning more.

Bubble-poppers show their true colors

See Bubbles on page 3

FRONT BURNER

Investment and Capital Gains Indexing

Sen. William Armstrong

Every now and again, an idea comes before Congress which is so compelling you think surely it will be enacted into law. Capital gains indexing is just such an issue. Only a passing acquaintance with tax policy is needed to grasp how unfair it is to tax phantom capital gains due to inflation. Such common-sense appeal explains why support for indexing covers the political spectrum. Yet, year after year, capital gains indexing doesn't quite make it into law.

But it should.

Because fairness has played such an important role in the formulation of tax policy, advocates of indexing have focused on the unfairness of taxing inflationary gains. So it should not be surprising that there remains some confusion as to how indexing affects the incentive to invest relative to an exclusion.

Contrary to popular belief, indexing can provide a much greater tax benefit to a vast majority of shareholders than would a 30% exclusion. A simple example can illustrate this point:

Suppose you purchase a share for $100 and you hold it for five years. Over that period, the annual inflation rate is 5%, and you face a 28% tax on your gains. In this case, only if your cumulative, pre-tax return exceeds 92% will the President's proposal provide as much tax relief as does indexing. On an annual basis, that translates into a total annual return of 13.5% for each of the five years. While some

See Armstrong on page 2

William Armstrong, Republican Senator from Colorado, serves on the Senate Committee on Finance.

Ed. Note: The Front Burner is a forum for participants in the fiscal arena to express their opinions on tax and budget issues. These opinions are not necessarily those of the Tax Foundation. Editorial replies are encouraged.

Tax Foundation

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businesses offer their owners such high rates of appreciation, certainly far less than a majority perform so well. So, for the majority of American shareholders and businesses, indexing is the better way to go.

"Only a passing acquaintance with tax policy is needed to grasp how unfair it is to tax phantom capital gains due to inflation."

For some assets bearing taxable nominal gains, once the tax basis is adjusted for inflation, we find these same assets yield real losses. While correct tax policy dictates that a taxpayer should be allowed to deduct his real loss from any taxable income, the fact of the matter is the revenue drain of such a proposal would be prohibitive. Moreover, it might be too expensive even to allow a taxpayer to charge his real losses against his real gains. Many indexing proposals, therefore, would not allow taxpayers to use real losses to offset other gains or other income.

Some have argued the difficulty posed by tax losses due to indexing implies that indexing is, itself, somehow defective policy. Nothing could be further from the truth. The real capital loss problem arises because capital gains indexing works so well to eliminate the tax on phantom gains.

A second example will serve to make this point clear:

Suppose you buy one share each in Company A and Company B, each share costs $100, inflation and tax rates are as before, and you hold both shares for five years. Company A's shares appreciate at the rate of 4 percent per year and B's appreciate at 15 percent per year. After five years, you will pay almost $25 in combined capital gains tax under the President's proposal.

If you are allowed to index your tax basis, your share in Company A shows a real loss which, we assume, you are unable to charge against any real gains or other income. So there is no tax consequence to the purchase and sale of this share.

The appreciation of Company B's share leaves you with a tax liability of just under $22 after indexing. When the tax consequences of both purchases and sales are combined, indexing will save you $3 in tax as compared to the President's plan, even though, under indexing, you lost any benefit from using the tax loss from the underperforming share.

"Contrary to popular belief, indexing can provide a much greater tax benefit to a vast majority of shareholders than would a 30% exclusion."

There is another reason to support indexing. As recent history has shown, capital gains exclusions tend to be short-lived. If we enact an exclusion this year, we can be certain the next time we try to reform the tax code, repeal of the exclusion will be a key means of paying for it, just as it was in 1986. But indexing, once enacted, is much more likely to remain a long-term fixture of our tax system. If we reduce the capital gains tax, in part to encourage long-term investment, we should be sure the changes will last more than a few short years.

"If we enact an exclusion this year, we can be certain the next time we try to reform the tax code, repeal of the exclusion will be a key means of paying for it, just as it was in 1986. But indexing, once enacted, is much more likely to remain a long-term fixture of our tax system."

Tax Foundation Report Explodes the Myth of Popping the Bubble

A new report entitled *The Myths and Misunderstandings of Popping the Bubble,* published by the Tax Foundation and authored by Byrle M. Abbin, asserts that the "bubble," despite its appearance, is not regressive and is preferable to the proposals that have been put forward to eliminate it. The "bubble" is a 33 percent marginal tax rate levied at certain taxable-income levels in order to phase out the benefits of the 15 percent tax bracket and the personal exemptions for high-income taxpayers.

Mr. Abbin, managing director, Office of Federal Tax Services at Arthur Andersen, points out that any plan to "pop the bubble" by levying a 33 percent rate on all income above these ranges will increase pressure to "reverse the basic tradeoff of lower rates for a broader tax base that formed the foundation of the Tax Reform Act of 1986."

Abbin goes on to cite statements by members of Congress from both sides of the aisle, Senator Bill Bradley (D-NJ) and Rep. Richard Schulze (R-PA), who understand the purpose of the bubble. Bradley is quoted in a "dear colleague" letter: "'Unfortunately, many people believe — incorrectly — that taxpayers subject to the 33% rate are being treated unfairly compared to higher income taxpayers whose top marginal rate is 28%. In fact,' Bradley continued, 'the bubble does not reward the rich. On the contrary, it enhances the tax system's progressivity.'"

Finally, Abbin addresses the issue of motive for changing the rate structure. He suggests that while the bubble could be eliminated in a revenue-neutral fashion, most proposals to do away with it talk about "fairness and clarity" but would in fact yield billions of dollars in additional tax revenue.

Now Available

A new Tax Foundation *Issue Brief* entitled *The Myths and Misunderstandings of Popping the Bubble*. By Byrle Abbin, 4 pp. $10 + $2 p/h.

Bubbles from page 1

when they propose alternatives. Although it is quite possible to eliminate the bubble without raising or lowering federal revenue, their most common suggestion is to extend the top of the bubble over the rest of the income range, creating a separate, higher marginal rate. This would extract billions of extra tax dollars under the guise of fixing the tax structure.

Bubbles Bubbles Everywhere

The individual income tax rate bubble has received much attention, but it is by no means the only bubble. Simply put, a bubble arises whenever the law requires a tax benefit or advantage to be reduced or eliminated as income increases. The net effect is to raise the effective tax rate of higher-income taxpayers compared to lower-income taxpayers who retain the full benefit of the provision.

Indeed, if Congress began popping every bubble it could find in the manner suggested above, it would affect not only take-home pay, but rental real estate income, effective corporate income tax rates, the applicability of the alternative minimum tax, and the child care credit, just to name a few.

The Corporate Income Tax Bubble

Corporate taxpayers are also subject to a rate structure bubble because some income is taxed at 15 percent (first $50,000 of taxable income) and some at 25 percent (between $50,000 and $75,000), rather than having all income taxed at the top rate of 34 percent. Taxable income above $100,000 is subject to an extra 5 percent tax rate until the tax saved from using the lower tax rates is fully recouped ($335,000). The process of computing the corporate income tax is similar to that of computing the individual income tax. Therefore, the rate surcharge was applied to both corporate and individual taxpayers to accomplish the same purpose.

The Earned Income Credit Bubble

The earned income credit bubble arises because the rate of credit is decreased and eventually eliminated as adjusted gross income (AGI) increases. The code allows a tax credit equal to $953 or 14 percent of earned income, whichever is lower. The credit is reduced by 10 percent of AGI or earned income over $10,730 and is eliminated when AGI exceeds $20,264. Therefore, the bubble denies the credit to higher-income taxpayers, enhancing progressivity.

The Rental Real Estate Bubble

Individual taxpayers are able to deduct as much as $25,000 of rental real estate losses annually. However, taxpayers with AGI in excess of $100,000 must reduce the $25,000 amount by 50 percent of each dollar of modified AGI (AGI after certain adjustments) in excess of $100,000. The result is that taxpayers with modified AGI higher than $150,000 ($100,000 + $50,000) cannot currently deduct otherwise deductible rental real estate losses. The phaseout of the deductible rental real estate losses creates a bubble and accomplishes a purpose similar to the 5 percent surcharge in the individual and corporate rate structures.

The Alternative Minimum Tax Bubble

The Alternative Minimum Tax includes a built-in bubble because the code requires a phaseout of the $40,000 exemption in computing the AMT liability. The $40,000 exemption amount serves as a floor in determining whether or not individual or corporate taxpayers are subject to the AMT. The AMT generally will not apply unless alternative minimum taxable income (AMTI, taxable income plus tax preferences and adjustments) exceeds the $40,000 exemption, after considering the phaseout.

The phaseout is applied to corporate taxpayers by reducing the exemption amount by 25 percent of AMTI in excess of $150,000. Therefore, the exemption is fully phased out when AMTI exceeds $310,000 [$150,000 + ($40,000/25%)]. The AMT exemption for single individuals is reduced by 25 percent of each dollar of AMTI between $112,500 and $232,500 ($150,000-$310,000 for married filing jointly). The critical difference between the phaseout for corporate and individual taxpayers is where the phaseout begins. But for both corporate and noncorporate taxpayers, the phaseout of the $40,000 is likely to increase the effective rate of taxation.

The Social Security Bubble

The Social Security bubble causes recipients with income above certain levels to be taxed on earnings above a certain level. Under the Code, Social Security earners are taxed on the lesser of 50 percent of Social Security benefits or the excess of modified AGI over a $25,000 base for single individuals or a $32,000 base for joint filers. As with the other bubbles, the Social Security tax provisions attempt to increase the effective tax burden on Social Security receipts as income increases.

The Child Care Credit Bubble

We see a bubble in the child care credit because the rate of the credit is reduced from a maximum of 30 percent to 20 percent for taxpayers with AGI between $10,000 and $30,000. The rate of credit is reduced by 1 percent for each $2,000 increment over $10,000. So taxpayers with AGI above $30,000 receive a 20 percent credit on qualified expenses of up to $4,800 ($2,400 per qualified dependent) rather than the 30 percent rate. The proportional reduction of the 30 percent credit to 20 percent enhances progressivity by granting a more substantial credit for lower-income taxpayers.

Conclusions

The legislative push to pop the so-called bubble in the rate structure for individual taxpayers seems to be based on a misunderstanding of the statutory tax rate drop from 33 to 28 percent. The rate increase (5 percent surcharge) from 28 to 33 percent is merely a device to increase the progressivity of the individual income tax.

The phaseout of tax savings from many provisions in the code is accomplished by creating a bubble. Sometimes a tax rate surcharge is used, sometimes not. But singling out the individual income tax rate bubble as an "anomaly" is deceptive and could lead to bad tax policy.

Dallas Seminar Brings Members Together to Discuss Economic And Tax Policy Outlook

A large group of tax executives gathered June 14 in Dallas where James C. Miller III and T. Boone Pickens treated them to informative and entertaining presentations on the nation's economic and tax policy. In addition, three panels of experts gave specific talks on economics, taxation, and accounting trends.

James P. Bryant, Vice President & Director of Corporate Taxes for J.C. Penney Company, served as chairman of the program and introduced Dr. Miller, who is co-chairman of the Tax Foundation and former Director of the Office of Management and Budget under President Reagan. Miller painted a broad picture of the nation's current economic situation and made several predictions for the coming years. He sees short-term interest rates as stable, though occasionally buffeted by the Federal Reserve's reactions to inflation, but in the long term, he predicts interest rates will come down. Also on the bright side, he sees less danger of protectionist tax policy as long as the trade deficit continues its erratically downward course.

W. Michael Cox, Vice President and Economic Advisor, Federal Reserve Bank of Dallas

T. Boone Pickens, General Partner, Mesa Limited Partnership

On the worrisome side, Miller sees a surge in regulations from many government agencies, and he feels the new minimum wage jeopardizes employment levels, especially for black youth.

On the budget, Miller held forth against the necessity of a tax increase, asserting that plenty of additional federal revenue will be garnered from legislation already passed that has just recently gone into effect.

The first panel of the day presented more views of economic policy. Speakers included W. Michael Cox, Vice President and Economic Advisor, Federal Reserve Bank of Dallas; Ronald O. Durant, Senior Staff Economic Advisor, Exxon Corporation; and Jared Hazleton, Director, Center for Business & Economic Analysis, Texas A&M University.

The second panel focused on tax policy. The speakers were Paul Stein, Corporate Tax Manager, Texas Industries, Inc.; and Vernon W. Walker, Vice President & Controller, Blue Cross and Blue Shield of Texas.

The final panel on accounting trends featured Larry Dildine, Director of Tax Economics, Price Waterhouse; and Daniel J. Frisch, Principal, Economics Group, KPMG Peat Marwick.

Luncheon speaker T. Boone Pickens wrapped up the program with an address on corporate accountability to stockholders. One of America's best-known entrepreneurs, Pickens pointed out that among America's top 200 companies, stock ownership by management was only 3 percent. Pickens claimed that boosting this figure would go a long way towards making the U.S. more competitive.

James P. Bryant, Vice President & Director of Corporate Taxes, J.C. Penney Company

On the subject of taxes, Pickens complained of the tax code's complexity and instability. Complexity deters investment and innovation, and due to Congress's habit of continually rewriting the code, American businesses can not make long-range plans that take taxes into account.

Boone Pickens at left chats with Ron Bunn, Director of Corporate Development, Tax Foundation; Richard Freling, Esq., Johnson & Gibbs; Wayne Gable, President, Tax Foundation; and James C. Miller III, Co-chairman, Tax Foundation.

Ronald O. Durant, Senior Staff Economic Advisor, Exxon, U.S.A.

VIEWPOINT

With the continued expansion of international trade and the emergence of new markets overseas, how could federal tax policy best ensure U.S. corporate competitiveness?

Cyrus J. Halpern
Tax Vice President,
Federal & International Taxes, AT&T

In order to ensure U.S. corporate competitiveness, the federal budget deficit issue must be resolved in a manner that is equitable across all segments of the economy and reduces the cost of capital. Deficit reduction must be accomplished with sound tax policy rather than "quick fixes." In addition, federal tax policy should encourage rather than hinder U.S. businesses by removing or simplifying restrictive and complex provisions, including those that govern taxation of foreign source income.

A more stable tax environment which would allow business to plan for long-term projects and investments is badly needed. Incentives that currently exist, such as the research and experimentation credit, should be permanently extended.

Norman B. Ture
President, Institute for Research on the Economics of Taxation

The rapid emergence of a global economy presents every nation's businesses great opportunities to expand their operations and to enhance their productivity. Whether American business can take advantage of these opportunities will depend in significant measure on reducing the present income tax barriers to the foreign operations of U.S. multinational businesses. The foreign tax provisions of the federal income tax have long had a punitive cast; the 1986 Tax Reform Act greatly complicated these provisions and made them far more of a barrier to the free and efficient flow of capital and business ventures across national borders. American business competitiveness is impaired by our protectionist tax system. Protectionism, whether of the trade or tax variety, is at odds with efficiency, growth, and productivity advances.

The foreign tax provisions of the federal income tax cry for constructive reform. Undertaking that reform should begin with repeal of most, if not all, of the changes in those provisions enacted in the 1986 tax reform legislation.

Robert N. Mattson
Assistant Treasurer
IBM

It is often a simply expressed idea that can turn minds and effect change. We all know this idea. It was the foundation of the United States Tax Reform Act of 1986 and has spread as a worldwide tax reform movement.

The idea is that marginal tax rates, not average tax rates, govern decisions to work, save and invest. Innovation and creativity follow. In fact, it is hard to understand why the idea took so long to take hold.

The tax rate cut in the 1986 Act has had much broader and more fundamental effects than just lower U.S. federal taxes. States including California, Minnesota, New Hampshire, New York, Ohio, Oregon, Pennsylvania, South Carolina and Vermont, have reduced their high corporate tax rates following the lead of the 1986 federal corporate rate cut. But even more critical to the competitiveness of U.S. companies operating abroad, a host of foreign nations have followed the U.S. leadership culminating recently with Sweden's corporate rate cut from 52 percent to 30 percent.

Nations that move toward taxing economic activity at lower marginal tax rates have the competitive edge. The United States found its way in the 1986 Tax Reform Act by broadening the tax base in order to lower marginal tax rates. It would be an act detrimental to American living standards, and especially cruel and cynical to the long-term interests of the poor and middle class to turn back and dismiss this simple idea.

Low and even lower rates can be a lasting idea.

Viewpoint ***is designed to bring concise opinions from experts in tax and fiscal policy to the readers of*** **Tax Features.** ***Every two months a question that is currently being debated by policymakers and the media will be addressed in this column. Editorial replies are encouraged.***

Major State Taxes and Rates

as of July 15, 1990

State	Income Taxes: Corporate	Income Taxes: Individual	General Sales and Use Tax	Gasoline Tax (per gallon)	Cigarette Tax (per pack of 20)	Poperty Tax
Alabama	5% (F)	2 to 5% (F)	4% (a)	11 cents	16.5 cents	X
Arizona	9.3 (F)	3.8 to 7 (F)	5 (a)	17 (b)	15 (b)	X
Arkansas	1 to 6	1 to 7	4 (a)	13.5	21	X
California	9.3 (c)	1 to 9.3 (c)	5 (a, d)	9 (b)	35	X
Colorado	5 to 5.3 (d)	5 (c)	3 (a)	20 (b)	20	X
Connecticut	11.5 (e, f)	1 to 14 (g)	8	22 (b)	40	X
District of Columbia	10 (f)	6 to 9.5	6	18	17	X
Georgia	6	1 to 6	4 (a)	7.5 + 3% of retail	12	X
Hawaii	4.4 to 6.4	2 to 10	4 (a)	19.8 to 27.5	40% of wholesale	
Idaho	8	2 to 8.2	5	18	18	X
Illinois	4.8 (h)	3	6.25 (a)	19	30	X
Indiana	3.4 (i)	3.4	5	15	15.5	X
Iowa	6 to 12 (F, j)	.4 to 9.98 (F,c)	4 (a)	20	31	
Kansas	4.5 (f)	3.65 to 8.75 (k)	4.25 (a)	16 (b)	24	X
Kentucky	3 to 7.25	2 to 6 (F)	6 (a)	15 (l)	3	X
Louisiana	4 to 8 (F)	2 to 6 (F)	4 (a)	20	16	X
Maine	3.5 to 8.93	2 to 8.5	5	17	31 (b)	X
Maryland	7	2 to 5	5	18.5	13	X
Massachusetts	9.5 (m)	5.95 (n)	5	17 (b)	26	X
Michigan	2.35	4.6	4	15	25	X
Minnesota	9.5 (b, c)	6 to 8.5 (o)	6 (a)	20	38	X
Mississippi	3 to 5	3 to 5	6	18 (d)	18	X
Missouri	5 to 6.5 (F, e)	1.5 to 6 (F)	4.225 (a, d)	11	13	X
Nebraska	5.17 to 7.24 (b)	2 to 5.9 (b)	5 (a)	21.9 (l)	27	X
New Jersey	9 (f)	2 to 7	7	10.5	40	X
New Mexico	4.8 to 7.6	1.8 to 8.5	5	16	15	X
New York	9 (c, f)	4 to 7.875 (d, p)	4 (a)	8	39	
North Carolina	7	6 to 7	3 (a)	21.5	2	X
North Dakota	3 to 10.5 (F, c)	2.67 to 12 (F, q)	5	17	30 (d)	X
Ohio	5.1 to 8.9	.743 to 6.9	5 (a)	20	18	X
Oklahoma	6	.5 to 10 (F, k)	4.5 (a)	16	23	
Pennsylvania	8.5	2.1	6 (a)	12	18	X
Rhode Island	9	22.96% of modified Federal income tax	7 (d)	20 (l)	37	X
South Carolina	5	3 to 7 (d)	5 (a)	16	7	X
Tennessee	6	6 (g)	5.5 (a)	20	13	
Utah	5	2.55 to 7.2 (F)	5 (a)	19	23	X
Vermont	5.5 to 8.25	28% of Federal income tax (d)	4	15 (d)	17	X
Virginia	6	2 to 5.75	3.5 (a)	17.5	2.5	X
West Virginia	9.3 (d)	3 to 6.5 (c)	6	15.5	17	X
Wisconsin	7.9	4.9 to 6.93	5 (a)	21.5 (l)	30 (e)	X
Florida	5.5 (c)		6 (a)	4 (r)	33.9	X
Nevada, South Dakota, Texas, Washington, Wyoming	These 5 states have no corporate income tax	These 7 states have no individual income tax	5.75 (a)	18	35 (d)	X
			4 (a)	18	23	
			6.25 (a)	15	41	
			6.5 (a)	22 (b, l)	34 (d)	X
			3 (a)	9 (l)	12	X
Alaska	1 to 9.4		These	8	29	X
Delaware	8.7	3.2 to 7.7 (F)	5 states	16 (b)	14 (b)	
Montana	6.75 (f, s)	2 to 11 (F)	have no	20	18	X
New Hampshire	8	5 (g)	general	16	25	X
Oregon	6.6	5 to 9 (F)	sales tax	18 (b)	28	X

(X) Indicates state levies a property tax.
(F) Allows federal income tax as a deduction.
(a) Local taxes are additional.
(b) Future increases scheduled under current law.
(c) Alternative minimum tax is imposed.
(d) Future reductions scheduled under current law.
(e) Alternative methods of calculation may be required.
(f) Corporate surtax is imposed. Connecticut – 20%, District of Columbia – 5%, Kansas – 2.25%, New Jersey – .375%, New York – 15%, Montana – 5%.
(g) In Connecticut, New Hampshire, and Tennessee, rates apply to income from dividends and interest. Capital gains are taxed at 7% in Connecticut.
(h) Additional 2.5% personal property replacement tax imposed.
(i) A supplemental net income tax is imposed at 4.5%.
(j) Franchise tax is 5% of taxable net income.
(k) In Kansas and Oklahoma, the higher rates apply to taxpayers deducting Federal income tax.
(l) Tax rate is periodically adjusted administratively.
(m) Excise tax is imposed equal to the greater of $455.
(n) Tax of 12% on income derived from interest, dividends, and capital gains.
(o) Additional tax is imposed on income over specified levels, varying with filing status.
(p) Qualified taxpayers may elect to pay alternative taxes at varying rates.
(q) Optional tax of 14% of taxpayers federal income tax liability.
(r) In addition, Florida imposes a 6.9 cent sales tax on gasoline.
(s) 7% rate for corporations using water's edge apportionment.

Source: Compiled by Tax Foundation from survey of state revenue offices and data reported by Commerce Clearing House through June 15, 1990.

FY1989 State Taxes Rise $20 Billion; Increase 7.5 Percent Over FY1988

State tax revenues have soared nearly $20 billion in fiscal year 1989, a 7.5 percent increase from last year. Revenues for states reached a record high of $284 billion, up $19.9 billion from $264.1 billion in FY 1988. Increased rates in sales, gasoline, and corporate and personal income over the past years have led to new revenue highs.

Sales Tax Is Biggest Haul

For FY1990, more than ten states have increased their general sales tax rates. Overall, general sales taxes generate the most revenue for states. They provided $93.4 billion of revenue, 32.9 percent of the total revenue for the 50 states. Connecticut still leads the nation with an 8 percent sales and use tax, followed closely by New Jersey and Rhode Island (7 percent), Washington (6.5 percent) and Illinois and Texas (6.25 percent).

On the lower end of the scale, Colorado, North Carolina, and Wyoming levy a 3 percent sales tax. No state general sales tax is imposed in Alaska, Delaware, Montana, New Hampshire, and Oregon.

Personal Income Tax

Personal income tax was the second most productive revenue source, contributing $88.7 billion in FY'89, for 31.2 percent of total tax receipts, a 10.7 percent increase from fiscal 1988 receipts. Income tax revenues have increased more in fiscal 1989 than any other tax revenue source. New Jersey recently imposed the most notable increase in individual income rates for 1990 by raising the top rate from 3.5 percent to 7 percent.

The tax rate schedules are progressive in all but six of the 43 states that levy a broad-based personal income tax. Colorado, Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania apply a flat rate regardless of income level. In Rhode Island and Vermont, income taxes are levied as a percentage of Federal individual income tax obligations.

Corporate Income Tax

Corporate income tax proved to be another major revenue raiser for the states, raising $23.9 billion. The maximum corporate income tax rate is highest in Iowa (6 to 12 percent), Connecticut (11.5 percent), and North Dakota (3 to 10.5 percent). (This ranking omits several states which have higher income tax rates but allow for deductions.) Five states continue to dispense with the corporate income tax as well as the individual income tax - Nevada, South Dakota, Texas, Washington, and Wyoming. Florida and Alaska have no individual income tax.

Motor Fuels

Taxes on motor fuels contributed 6.3 percent to total tax receipts. Gasoline taxes are currently the highest in Hawaii (where combined state-local rates range from 19.8 to 27.5 cents per

See State Taxes on page 8

PRESIDENT'S MESSAGE

Capping Deductions Unlikely To Solve Budget Deficit

Wayne Gable

The Tax Foundation has long been known for including all levels of government in its analyses of taxing and spending. Therefore, it is not surprising that as the budget summit churned out ideas for increasing federal revenues, people should look to the Foundation for the state-level effects of these proposals. Recently the capping of state and local income tax deductibility was reported to be a likely choice of the summiteers.

The Foundation responded by publishing in the *Wall Street Journal* a breakdown of how much money each state collects per capita using state and local income taxes. The wide disparity of these figures separates the states into clear categories of winners and losers should the deduction be capped or eliminated. Naturally, the residents of states which rely heavily on state and local income taxes for revenue are the losers who will pay the bulk of any new federal revenue raised by limiting the deduction. Hardest hit among them would be the residents of the District of Columbia, New York, and Massachusetts. These same states are already at or near the top of the list for total per capita federal taxes; so the loss of state/local deductibility would be doubly burdensome.

The winners on this issue are easy to find. Seven states levy no state or local income taxes, so the residents of Florida, Nevada, South Dakota, Texas, Washington, Wyoming and Alaska would not pay a cent in extra tax.

We have analyzed the deduction for property taxes in the same manner. Residents of Alaska, the District of Columbia, and New Hampshire have the highest per capita property taxes and would be the big losers should its deductibility be capped or eliminated. In fact, thirty-eight states collect more per person in property taxes than in state and local income taxes. The states which rely the least on property tax are Alabama, New Mexico, and Arkansas.

The prospect of paying higher taxes by losing deductions is irritating in itself to any taxpayer who uses them, especially if he lives in a high-tax state where the deduction is substantial. But to add insult to injury, the summiteers claim this tax increase has the noble motive of lowering the deficit. As I mentioned in this column in May, budget summits have failed throughout the 1980s. They have always included tax increases and promised spending restraints, but while the tax increases go immediately into effect, the spending restraints come to naught, and the deficit rises. In fact, the years which were not preceded by budget summits, 1984 and 1987, saw huge improvements in the deficit.

Now that the summit talks are showing signs of breaking down, perhaps we have a greater chance of deficit reduction than when they were "making progress." In any event, the Tax Foundation will continue to bring the facts to bear on taxes and spending at the federal, state, and local levels.

State Taxes from page 7

gallon), Connecticut and Washington (22 cents), and Nebraska (21.9 cents) . Florida levies the lowest rate , 4 cents per gallon; however, gasoline is also subject to a 6.9 cent general sales tax. New York and Alaska follow closely with an 8 cent rate.

Cigarette Taxes

Cigarette taxes also make a notable contribution to state tax revenues. In FY'89, states collected $5 billion of their total revenues from tobacco product excises. Connecticut and New Jersey top the ranks with a 40 cent rate per pack of twenty cigarettes. North Carolina levies the lowest rate at 2 cents.

See table on page 6 for more detail.

Now Available

A new Tax Foundation *Special Report* entitled *Survey of State Tax Rates and Collections*, 4 pp. $10 + $2 postage/handling.

Mark Your Calendars

The Tax Foundation's
42nd Annual Conference
and
53rd Annual Dinner
will be held at the
Waldorf-Astoria Hotel
in New York City
on December 5, 1990

International Investment Subject of September Tax Foundation Seminar

Congressmen Hank Brown (R-Co) and Phil Crane (R-IL), both of the House Ways and Means Committee, will speak at an upcoming Tax Foundation seminar entitled "Assessing U.S. Tax Policies Toward International Investment — An Opportunity for Change." The half-day seminar will be held the afternoon of September 25, 1990, at the Washington Court Hotel on Capitol Hill. An informal cocktail reception will follow.

Dr. Gary Hufbauer, professor of international financial diplomacy at Georgetown University, will follow Congressman Brown's keynote address with an economic overview of the issues.

The early afternoon session will concentrate on the U.S. tax treatment of American investment abroad. At press time, three speakers were confirmed: Raymond Haas, International Tax Partner, Ernst & Young; Dick Hammer, International Tax Partner, Price Waterhouse; and John F. Brussel, International Tax Director, AT&T.

The second session will examine the tax treatment of foreign investment coming into the U.S. Confirmed to speak are: Elliot L. Richardson, Senior Partner, Milbank, Tweed, Hadley & McCloy; James M. Carter, Senior Tax Counsel, ICI Americas; Bruce R. Bartlett, Deputy Assistant Secretary for Economic Policy; U.S. Department of the Treasury; Peter Barnes, Deputy Assistant International Tax Counsel, U.S. Department of the Treasury; Catherine T. Porter, Partner, Miller & Chevalier, Chartered; and Richard Pratt, Economic Counselor, Embassy of Great Britain.

For more information, please call Paul Merski or Sedef Onder at 202-863-5454.

Tax Features

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